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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
as successor to the Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF FOR COLORADO NATIONAL BANKSHARES, INC. AND SUBSIDIARIES AS AMICUS CURIAE SUPPORTING PETITIONER

JAMES E. BYE
Counsel of Record
RICHARD G. WILKINS
DOUGLAS A. PLUSS
CHARLES B. BRUCE, JR.
HOLME ROBERTS & OWEN
Suite 4100
1700 Lincoln Street
Denver, Colorado 80203
(303) 861-7000
Counsel for Amicus Curiae

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TABLE OF CONTENTS

	Page
INTEREST OF THE AMICUS	1
SUMMARY OF THE ARGUMENT	2
ARGUMENT	3
I. A *PER SE* NON-AMORTIZATION RULE CANNOT BE RECONCILED WITH CURRENT LAW	3
A. A *Per Se* Rule Cannot Be Reconciled With the Language of the Controlling Statute and Regulation	3
B. A *Per Se* Rule Directly Conflicts With the Legal Standard That Has Been in Effect for Nearly Twenty Years	5
II. THE THIRD CIRCUIT HAS NOT ARTICULATED A PERSUASIVE JUSTIFICATION FOR DEPARTING FROM THE *HOUSTON CHRONICLE* TEST	7
A. A Conclusion That the Stream-Of-Income Method Does Not Result in a Value That Is Separate and Distinct From Goodwill Does Not Mean Other Methods of Valuation Cannot Produce a Value That Is Separate and Distinct From Goodwill	7
B. A Conclusion That a Customer-Based Intangible Is Not Separate and Distinct From Goodwill Does Not Mean That Supplier-Based Intangibles Cannot Be Shown To Be Separate and Distinct From Goodwill	9
III. THE *PER SE* RULE IS UNWISE BECAUSE IT CREATES A PROCRUSTEAN BED INTO WHICH COURTS MUST FORCE THE FACTS OF DIFFERING CASES	11
CONCLUSION	14

TABLE OF AUTHORITIES

CASES — Page

Citizens and Southern Corp. v. Commissioner, 91 T.C. 463 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990) 5, 8, 13
Colorado Nat'l Bankshares, Inc. v. Commissioner, 60 T.C.M. (CCH) 771 (1990), *appeal filed*, No. 91-9019 (10th Cir. filed Sept. 27, 1991) ..... *passim*
Decker v. Commissioner, 864 F.2d 51 (7th Cir. 1988) 5
Dickman v. Commissioner, 465 U.S. 330 (1984), *reh'g denied*, 466 U.S. 945 (1984) 8
Donrey, Inc. v. United States, 809 F.2d 534 (8th Cir. 1987) 5
Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974) ..... *passim*
Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253, 97 Tax Ct. Rep. (CCH) No. 16 (1991), *appeal filed*, No. 92-1045 (4th Cir. filed Jan. 15, 1992) .. 10
McCarthy v. United States, 807 F.2d 1306 (6th Cir. 1986) 5
Panichi v. United States, 834 F.2d 300 (2d Cir. 1987) 5
Ralph W. Fullerton Co. v. United States, 550 F.2d 548 (9th Cir. 1977) 5
Southern Bancorporation, Inc. v. Commissioner, 847 F.2d 131 (4th Cir. 1988) 5

STATUTES

Internal Revenue Code of 1954 (26 U.S.C.) :
Section 167 4
Section 167(a) 4, 6
Section 7872 8

REGULATIONS AND ADMINISTRATIVE MATERIALS

Treas. Reg. § 1.167(a)-3 ..... 4, 6
Rev. Rul. 74-456, 1974-2 C.B. 65 6

TABLE OF AUTHORITIES—Continued

OTHER AUTHORITIES — Page

Paul H. Frankel, *Tax Court-Trial of Cases*, 153-4th Tax Mgmt. Income (BNA) at A-23 (Apr. 8, 1991) 13
William A. Raabe, Gerald E. Whittenburg, and John C. Bost, West's Federal Tax Research 113 (West 1987) 13

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INTEREST OF THE AMICUS

Colorado National Bankshares, Inc. and Subsidiaries ("CNB") has a vital interest in this case. In a case currently before the United States Court of Appeals for the Tenth Circuit, CNB is urging the Tenth Circuit to affirm a decision of the Tax Court, which holds that CNB is entitled to amortize acquired core deposit intangibles. *Colorado Nat'l Bankshares, Inc. v. Commissioner*, 60 T.C.M. (CCH) 771 (1990), *appeal filed*, No. 91-9019

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[1] Colorado National Bankshares, Inc. and Subsidiaries submits this brief with the consent of both parties. Consent letters from the parties, copies of which previously have been mailed to the Clerk of the Court, are filed with this brief.

(10th Cir. filed Sept. 27, 1991). In the *CNB* case, as here, the government advocates a *per se* rule, denying as a matter of law amortization of customer- or supplier-based intangible assets acquired in the purchase of a going concern. Although the facts in the *CNB* case are distinguishable in a number of significant respects from the present case, this Court's decision as to whether Morning Ledger is entitled to amortize its acquired subscriber base, if written broadly, could influence the final outcome of the *CNB* case.

SUMMARY OF THE ARGUMENT

The Court of Appeals' opinion is inherently contradictory. Although the Third Circuit conceded that the amortization of intangible assets presents a factual question, Pet. App. 16a, the court nevertheless decided the case based on a *per se* rule. The *per se* rule would force all cases involving the amortization of customer- or supplier-based intangibles acquired as part of a going concern into a single mold—regardless of actual facts or economic reality—and deny amortization deductions as a matter of law. Pet. App. 28a-29a. This Court should not adopt such an inflexible approach.

The *per se* rule relied upon by the Third Circuit cannot be reconciled with the language of the controlling statute and regulation, represents an unnecessary departure from the current facts and circumstances test used to distinguish between amortizable intangible assets and non-amortizable goodwill, and—because of its inflexibility—may force courts to stretch the facts of individual cases to fit the rule. This Court, therefore, should reverse the decision below and refuse the government's invitation to adopt a *per se* rule covering all intangible assets based on customers or suppliers, in all industries, acquired under differing facts and circumstances.

ARGUMENT

I. A *PER SE* NON-AMORTIZATION RULE CANNOT BE RECONCILED WITH CURRENT LAW

The Third Circuit began its analysis by acknowledging that the *Houston Chronicle* test "has become the standard for all subsequent related cases." Pet. App. 16a (citing *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974)). The court, furthermore, agreed with the government's statement that "the two-prong test articulated by *Houston Chronicle* was intended to inter the notion that some intangible assets, although not necessarily goodwill, [are] nonetheless so intertwined with goodwill as to be nondepreciable as a matter of law in all cases." *Id.* However, and notwithstanding the foregoing, the circuit court concluded that "the Service is correct in asserting that, for tax purposes, there are some assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." Pet. App. 28a-29a. This, of course, is the precise *per se* rule *Houston Chronicle* purportedly interred.

The *per se* rule should not be resurrected. The controlling statute and regulation are clear, and the previous cases are unanimous: whether a taxpayer is entitled to amortize a specific intangible asset is a question of fact to be determined at the trial court level. Accordingly, the Third Circuit erred in adopting a *per se* non-amortization rule.

A. A *Per Se* Rule Cannot Be Reconciled With the Language of the Controlling Statute and Regulation

To match accurately the expense of acquiring a capital asset with the income generated by that asset, the Internal Revenue Code and its implementing regulations allow for

the depreciation[2] of capital assets. Section 167(a) of the Code provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income." Treasury regulation section 1.167(a)-3 provides an annual deduction for intangible assets if the intangibles are "known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy . . . ." Treas. Reg. § 1.167(a)-3.[3]

Neither section 167 nor the implementing regulation sets forth a *per se* rule that denies, as a matter of law, amortization deductions with respect to customer- or supplier-based intangibles acquired in the purchase of a going concern. Admittedly, Treasury regulation section 1.167(a)-3 flatly prohibits the amortization of goodwill. However, the regulation does not define goodwill. Therefore, in a controversy involving the amortization of an intangible asset, the language of the controlling statute

[2] As a matter of terminology, "depreciation" deductions are allowed for tangible assets and "amortization" deductions are allowed for intangible assets.

[3] Treasury regulation section 1.167(a)-3 provides in full:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder.

and regulation requires a court to distinguish, on a factual, case-by-case basis, the value of the asset to be amortized from the value of goodwill.

B. A *Per Se* Rule Directly Conflicts With the Legal Standard That Has Been in Effect for Nearly Twenty Years

The modern legal standard used to distinguish amortizable intangible assets from non-amortizable goodwill was first articulated by the Fifth Circuit in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). Recognizing that the concept of goodwill cannot be defined with any precision, the court set forth the following factual test: a taxpayer is allowed to take amortization deductions with respect to any intangible asset "if the taxpayer properly carries the dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy." *Houston Chronicle*, 481 F.2d at 1250. Since 1973, each of the eight circuit courts that have addressed issues involving the amortization of intangible assets, including the Third Circuit, have unanimously adopted the *Houston Chronicle* test and recognized the factual nature of the test.[4]

One year after the *Houston Chronicle* case was decided, the Internal Revenue Service officially adopted the same test:

[4] *See* Pet. App. 16a; *Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 479 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990); *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988); *Southern Bancorporation, Inc. v. Commissioner*, 847 F.2d 131, 136-37 (4th Cir. 1988); *Panichi v. United States*, 834 F.2d 300, 301 (2d Cir. 1987); *Donrey, Inc. v. United States*, 809 F.2d 534, 537 (8th Cir. 1987); *McCarthy v. United States*, 807 F.2d 1306, 1310 (6th Cir. 1986); *Ralph W. Fullerton Co. v. United States*, 550 F.2d 548, 550 (9th Cir. 1977).

> The depreciability of assets of this nature [customer- or supplier-based intangibles acquired in the purchase of a going concern] is a *factual question*, the determination of which rests on whether the taxpayer establishes that the assets (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy.

Rev. Rul. 74-456, 1974-2 C.B. 65, 66 (emphasis added).

The Third Circuit attempted to justify its departure from the fact-based *Houston Chronicle* test by stating that "[i]n the context of the sale of a going concern, it is simply often too difficult for the taxpayer and the court to separate the value of [a customer- or supplier-based intangible] from the goodwill value of the customer relationship/structure." Pet. App. 29a. This statement demonstrates the need for a factual test as opposed to a *per se* rule.

The factual nature of the *Houston Chronicle* test results from the unique characteristics possessed by the myriad different intangible assets that can be acquired in the purchase of a going concern and from the elusiveness of the concept of goodwill. Precisely because it is "often difficult" to distinguish between amortizable intangible assets and non-amortizable goodwill, the trier of fact must be allowed to weigh all of the evidence presented in a case before deciding whether the value of the asset sought to be amortized is separate and distinct from the value of goodwill. The court's perceived difficulty is insufficient justification for a *per se* rule.

The Third Circuit's reliance on a *per se* rule in reaching its decision in this case is in direct conflict with section 167(a), Treasury regulation section 1.167(a)-3, and the fact-based legal standard that has been consistently applied by eight circuit courts for a total of nearly twenty years. Therefore, the Third Circuit's decision must be reversed by this Court.

II. THE THIRD CIRCUIT HAS NOT ARTICULATED A PERSUASIVE JUSTIFICATION FOR DEPARTING FROM THE *HOUSTON CHRONICLE* TEST

Based on the specific facts and circumstances of the case before it, the Third Circuit determined that, in valuing the acquired subscriber base using the stream-of-income method of valuation, Morning Ledger included "much or all of the value of the expectancy that those customers [would] continue their patronage—i.e., the goodwill of the acquired concern." Pet. App. 30a. In addition, the court ignored the clear difference between customer-based intangibles and supplier-based intangibles. In an apparent attempt to bolster the resulting conclusion that Morning Ledger was not entitled to amortize the subscriber base, the Third Circuit transformed its case-specific, factual premises into a *per se* rule applicable to all cases and all circumstances. The court's erection of a *per se* rule on these premises, however, evidences faulty inductive reasoning and represents an unnecessary departure from the *Houston Chronicle* test.

A. A Conclusion That the Stream-Of-Income Method Does Not Result in a Value That Is Separate and Distinct From Goodwill Does Not Mean Other Methods of Valuation Cannot Produce a Value That Is Separate and Distinct From Goodwill

From its premise that the stream-of-income method includes goodwill in valuing the subscriber base acquired by Morning Ledger, and therefore does not satisfy the *Houston Chronicle* test, the Third Circuit jumped to a *per se* rule, denying as a matter of law amortization deductions with respect to all customer- or supplier-based intangibles acquired in the purchase of a going concern. The court's premise, however, even if valid, does not mean that methods of valuation other than the stream-of-income method cannot produce a value for customer- or supplier-based intangibles that is separate and distinct from the value of acquired goodwill. For example, taxpayers have success-

fully shown that the cost-savings method of valuation produces a value for acquired core deposit intangibles that is separate and distinct from goodwill. *See, e.g., Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 480 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990).

A bank's right to use the core deposits [5] existing on the date of an acquisition is an intangible asset known as a "core deposit intangible." To the extent that a bank is able to use acquired core deposits to meet its existing loan demand, instead of being forced to turn to more expensive market alternatives for funds, the bank realizes a determinable cost savings.[6] The present value of the total cost savings is the value of the acquired core deposit intangible. In the *CNB* case, the Tax Court found that "[i]t is this benefit which [CNB] set up as an asset and depreciated." *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 789.

In valuing core deposit intangibles acquired in the purchase of an existing bank, the cost-savings method produces a value that is separate and distinct from the value of the goodwill acquired in the transaction. *See, e.g., Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 510 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990); *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 793. Thus, in the *CNB* case, the

[5] "Core deposits" are funds deposited in interest-free checking accounts, interest-bearing checking accounts ("NOW" accounts), and savings accounts. Core deposits are a bank's cheapest source of funds, are relatively insensitive to interest rate changes, and, when acquired, decline over a predictable period of time.

[6] In *Dickman v. Commissioner*, 465 U.S. 330, 336 (1984), *reh'g denied*, 466 U.S. 945 (1984), this Court recognized that "the use of valuable property—in this case, money—is itself a legally protectible property interest" and held that an interest-free loan results in a taxable gift from the lender to the borrower. The value of the gift is measured by the interest costs saved by the borrower. *See also* I.R.C. § 7872.

Tax Court allowed CNB to amortize only the value for its acquired core deposit intangible that could be demonstrated using the cost-savings method. *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 793.

The Third Circuit itself noted that the "preference for the cost[-savings] approach is not premised merely on some obscure aspect of financial theory. . . . [T]he difference in the two valuation approaches implicates the central legal dilemma at issue." Pet. App. 29a-30a. Although the court indicated that the stream-of-income method (when used to value a customer-based intangible) inherently includes much or all of the value of the goodwill of the acquired business, the court strongly suggested that, if Morning Ledger had valued the subscriber base using the cost-savings method, amortization of the subscriber base would have been allowed. Pet. App. 30a. The Third Circuit's own admission that valuation methods other than the stream-of-income method presented in the *Morning Ledger* case can be used to satisfy the *Houston Chronicle* test invalidates its *per se* rule, and demonstrates that the *per se* rule is an unnecessary departure from established law.

B. A Conclusion That a Customer-Based Intangible Is Not Separate and Distinct From Goodwill Does Not Mean That Supplier-Based Intangibles Cannot Be Shown To Be Separate and Distinct From Goodwill

From its premise that a particular customer-based intangible was not shown to be separate and distinct from goodwill under one set of facts, the Third Circuit constructed a *per se* rule, denying as a matter of law amortization deductions with respect to all customer- or supplier-based intangibles acquired in the purchase of a going concern. As with the court's reasoning regarding the stream-of-income method, this premise does not compel the adoption of a *per se* rule. In the core deposit cases, taxpayers have successfully demonstrated that core deposit

intangibles, which are supplier-based intangible assets, are separate and distinct from goodwill.

A bank does not generate profits from its core deposits;[7] it generates profits by lending money to its borrowers. When a bank acquires the core deposits of another bank, the purchaser gains the right to use the money deposited in the acquired core deposit accounts for an ascertainable period of time. Throughout that period, the core deposits are a readily available, low-cost source of funds.

In terms of generating profits, a bank's customers are its borrowers.[8] A bank's depositors, on the other hand, are its suppliers, supplying the bank with its raw material (lendable funds) at a below-market rate. In this respect, the acquisition of a core deposit intangible is much the same as a manufacturer's acquisition of the right to receive raw materials at a below-market price—*i.e.*, a favorable supply contract.

A favorable supply contract is valuable to a manufacturer because it lowers the manufacturer's cost of producing its product, and thereby increases its profit margin. Similarly, a supply of low-cost funds allows a bank to produce its product (loans) at a cost below that achievable using alternative sources of funds. In both instances the value of the asset is measured by the costs saved, rather than by the income attributable to the asset.[9]

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[7] Typically, a bank does not charge a service fee on savings accounts, and the fees charged on checking accounts do not fully cover the costs of maintaining the accounts.

[8] Banks and finance companies both generate profits by lending money at interest rates higher than the rates they must pay for the right to use the money. However, finance companies cannot accept deposits as a source of lendable funds; they issue commercial paper on the open market in much the same way that banks without sufficient core deposits are forced to issue certificates of deposit. Even though a finance company does not have depositors, it is not a business without customers; like a bank, its customers are its borrowers.

[9] *See, e.g., Ithaca Indus., Inc. v. Commissioner*, 97 T.C. 253, 97 Tax Ct. Rep. (CCH) No. 16 (1991), *appeal filed*, No. 92-1045 (4th Cir. filed Jan. 15, 1992) (taxpayer permitted to amortize favorable supply contracts valued using the same method employed by the Tax Court in valuing CNB's acquired core deposit intangibles—the cost-savings method).

The Third Circuit founded its *per se* rule on two determinations derived from the particular facts and circumstances of the *Morning Ledger* case. Regardless of the validity of these determinations, it does not follow that all customer- or supplier-based intangibles, in all industries, are non-amortizable under all facts and circumstances. Even if the Third Circuit's factual premises accurately represent the record of the *Morning Ledger* case, they have absolutely no validity in the context of other cases, particularly those involving the amortization of supplier-based intangibles valued using the cost-savings method. They do not, in short, support the creation of a *per se* rule applicable to *all* cases involving amortization of customer- or supplier-based intangibles. This Court, therefore, should not accept the government's invitation to adopt the *per se* rule advanced by the Third Circuit.

III. THE *PER SE* RULE IS UNWISE BECAUSE IT CREATES A PROCRUSTEAN BED INTO WHICH COURTS MUST FORCE THE FACTS OF DIFFERING CASES

The Third Circuit's opinion demonstrates the procrustean nature of a *per se* rule and the reason why such a rule should not be adopted by this Court. In an attempt to justify its departure from *Houston Chronicle*, the Third Circuit was forced to mischaracterize the factual findings made by various trial courts. Based on these mischaracterizations, the Third Circuit then claimed that the *Houston Chronicle* test was unworkable because trial courts were incapable of properly applying the two-prong test.

Based on its reading of the facts and circumstances surrounding Morning Ledger's purchase of the Booth Newspapers, the Third Circuit suggested that the district court collapsed the two-prong *Houston Chronicle* test into

a one-prong determination: whether the asset sought to be amortized, the subscriber base, had a determinable life that was capable of being ascertained with reasonable accuracy. Pet. App. 9a. In effect, the Third Circuit claimed that the district court confused an administrative task, *i.e.*, ascertaining a value for an asset, with one of the fundamental requirements for amortization, *i.e.*, that the taxpayer must factually demonstrate that the asset sought to be amortized has a value separate and distinct from the value of the acquired goodwill. Pet. App. 13a.[10]

To support its theory that trial courts are incapable of properly applying the *Houston Chronicle* test, and thus to justify its resort to a *per se* rule, the Third Circuit cited the Tax Court's opinion in *Colorado Nat'l Bankshares* and claimed that the Tax Court, too, had reduced the *Houston Chronicle* test to a one-prong determination. Without the benefit of viewing the evidence presented in the *CNB* case, the Third Circuit stated that "[t]he Tax Court rejected the Service's position, clearly adopting the view that any intangible asset possessing a determinable life and an ascertainable value is, by definition, not goodwill." Pet. App. 22a. To the contrary, however, the Tax Court actually required (1) proof that the core deposit intangibles CNB sought to amortize had values that were separate and distinct from the value of the goodwill of the acquired banks, *Colorado Nat'l Bankshares*, 60 T.C.M. (CCH) at 787-90, and (2) proof of a limited useful life, the duration of which was ascertainable with reasonable accuracy. *Id.* at 790-92.

The Tax Court recognized that it must "first decide whether [CNB] established that its core deposit intangibles have an ascertainable value separate and distinct

[10] If the Third Circuit did, in fact, base its decision on the district court's misapplication of the *Houston Chronicle* test, it was required to set forth the proper legal standard and remand the case to the district court for additional factual findings consistent with, and a proper application of, the *Houston Chronicle* test.

from goodwill." *Id.* at 787. After reviewing all of the evidence presented in the case, the Tax Court concluded: CNB "has proven that the core deposits intangible at issue here has an ascertainable cost basis separate and distinct from the goodwill and going concern value of the acquired banks." Id. at 789-90.[11]

The Third Circuit's tendency to view all customer- or supplier-based intangible assets acquired in the purchase of a going concern as being identical facilitated the court's mischaracterization of the *CNB* case. If the Third Circuit had not ignored the facts, *i.e.*, that the *CNB* case involved a supplier-based intangible valued using the cost-savings method, the court would have been forced to recognize that its decision in the *Morning Ledger* case was completely inapplicable to the *CNB* case.

[11] Contrary to the Third Circuit's assertion that the Tax Court reduced the *Houston Chronicle* test to a one-prong determination, the Tax Court has consistently required taxpayers to prove that, in addition to having a limited useful life, the asset sought to be amortized has a value separate and distinct from goodwill. *See, e.g., Citizens and Southern Corp. v. Commissioner*, 91 T.C. 463, 480 (1988), *aff'd per curiam without opinion*, 900 F.2d 266 (11th Cir. 1990) ("[a]s a threshold matter, petitioner must establish that deposit base is an asset separate and distinct from goodwill").

Judge Goffe's 1988 opinion in *Citizens and Southern* was reviewed by the entire Tax Court and affirmed *per curiam* by the Eleventh Circuit. It is significant to note that the *CNB* case, decided by the Tax Court only two years after *Citizens and Southern* and involving very similar facts, was issued as a memorandum decision. Tax Court decisions are released in memorandum form only when the Chief Judge of the Tax Court determines that the decision concerns the interpretation of a factual question and the application of those facts to established law. Paul H. Frankel, *Tax Court-Trial of Cases*, 153-4th Tax Mgmt Income (BNA) at A-23 (Apr. 8, 1991); *see also* William A. Raabe, Gerald E. Whittenburg, and John C. Bost, *West's Federal Tax Research* 113 (West 1987). Therefore, the Chief Judge, when he issued the decision below as a memorandum decision, signaled his belief that the court in *Colorado Nat'l Bankshares* applied the same legal standard set forth in *Citizens and Southern*.

In the *CNB* case, the taxpayer was able to demonstrate that the asset it sought to amortize (1) had a value that was separate and distinct from the value of goodwill and (2) had a limited useful life, the duration of which could be ascertained with reasonable accuracy. If the Third Circuit found that Morning Ledger did not satisfy the two-prong *Houston Chronicle* test with respect to the acquired subscriber base, the court should have disallowed the taxpayer's amortization deductions. It should not have adopted a *per se* rule. A finding that the facts of one case do not meet the *Houston Chronicle* test does not mean that the test cannot properly be met under any circumstances. The Third Circuit itself has demonstrated that, if a *per se* rule is to govern the amortization of intangible assets, the facts of amortization cases will have to be stretched to meet the rule.

CONCLUSION

Controversies involving the amortization of customer- or supplier-based intangible assets acquired as part of a going concern present questions of fact that must be answered by the trier of fact in each individual case. Thus, the *per se* rule adopted by the Third Circuit should be rejected.

Respectfully submitted,

JAMES E. BYE
Counsel of Record

RICHARD G. WILKINS
DOUGLAS A. PLUSS
CHARLES B. BRUCE, JR.

HOLME ROBERTS & OWEN
Suite 4100
1700 Lincoln Street
Denver, Colorado 80203
(303) 861-7000
Counsel for Amicus Curiae

June 2, 1992